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Financial Markets

Irving Trust

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(Noon)

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It's an election year, and interest rates are rising fast--so much for the political theory of interest rate determination. Politics, however, are not absent. Mr. Martin, a member of the FOMC and a Reagan appointee, has spoken out strongly against a policy of rising rates. Mr. Feldstein, Chairman of the President's Council of Economic Advisors, is going back to Harvard, but he's still in favor of Fed policy. Mr. Regan, Secretary of the Treasury, was content with Fed policy two weeks ago, but now he's not a fan of the Fed. Yet the political factors seem quite unimportant at the moment. The Fed is doing what it feels must be done. However, politics remind the Fed that the risks are great should those policies be in error. The worst scenario (politically) for the Fed would be for high rates to induce several consecutive quarters of anemic growth or even recession. What is the effect of these interest rates?

Interest rates are high. They appear even higher if put on a "real" basis. The point here is that inflation is much lower now than it was in 1980-1982, and although interest rates are lower too, the "real" interest rate is also quite high (here I define real interest as the nominal rate less CPI inflation over the past 12 months). Currently the real rate on three-month CDs is over 6% (11.4% on CDs less 5% inflation). This compares with -0.5%, 5.6%, and 6.1% in 1980, 1981 and 1982 respectively. For long bonds (20-year Treasury) the real rates were -2.2%, 3.4%, and 6.7% for 1980, 1981 and 1982 respectively; compare this to over 8% now. However, rates impact the economy with quite a lag. Also, rates need to be quite high to really slow the economy, and to do this the high rates must persist for quite a period of time. In this regard I believe the Fed is acting differently, more cautiously, than it was right after October 1979. Therefore, the risk of a Fed-induced recession is lessened.

One reason for the Fed to be cautious is the more fragile nature of the economy. Near-term economic developments are more a function of "normal" cyclical developments than of anything else, and these portend strength. But the underlying economy is not necessarily healthy. A lot of streamlining has been done to business operations, but we are only one year out of a severe recession. My favorite analogy for the economy is that of a prize fighter in the late rounds. The punch that he could shrug off in round 1 will knock him out in round 10. We have an economy staging a strong comeback from a beating in "the early rounds"; but some sectors such as farm and capital equipment remain quite weak, and the Fed can't forget the beating that the economy has already taken.

This is why the Fed will be more cautious. The weakened condition is an even more pronounced phenomenon for the LDCs. As the cyclical thrust of the U.S. economy wanes, the restrictive nature of and forces behind interest rates will be felt. Being aware of the lags of policy, the Fed will be careful. As for investors, they seem to "fear" much more than they "hope." The bond market has gone far beyond the ability of current real interest rates to explain its performance. Current yields seem to anticipate a significantly higher and enduring inflation rate. What evidence is there that that's a reasonable forecast?

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Market Yields

	5/11/84 (Noon)	Week Ago	Year Ago
Prime Lending Rate at Irving Trust Company	12.50%	12.00%	10.50%
Effective since	5/8/84		
Discount Rate at Federal Reserve Bank	9.00	9.00	8.50
Federal Funds	10.63	10.00	8.25
Repurchase Agreements	10.13	9.50	8.25
U.S. Treasury Issues			
Bills			
3 months	10.24	10.20	8.30
6 months	10.85	10.80	8.49
1 year	11.46	11.22	8.69
Coupons			
2 years	12.37	12.02	9.28
4 years	12.86	12.53	9.68
7 years	13.23	12.87	10.11
10 years	13.36	12.95	10.20
Long Bond	13.42	12.98	10.36
Negotiable Certificates of Deposit-Secondary Market			
1 month	11.00	10.50	8.25
3 months	11.40	10.65	8.30
6 months	11.90	11.00	8.45
1 year	12.30	11.50	8.80
Banker's Acceptances			
1 month	11.10	10.41	8.26
3 months	11.47	10.68	8.37
6 months	11.81	11.10	8.46
Eurodollar Deposits			
1 month	11.38	10.75	8.69
2 months	11.75	11.00	8.75
3 months	12.00	11.18	8.81
Commercial Paper - Prime Names			
Directly placed by:			
Finance Companies			
1 week	10.62	9.87	8.26
1 month	10.75	10.34	8.42
3 months	10.73	10.41	8.41
Bank Holding Companies			
1 month	10.19	9.83	7.97
Dealer Placed:			
3 months	11.36	10.62	8.41
New AA Corporate Utility Bond	14.75	14.30	11.30
Tax Exempt			
6 month Project Notes	5.80	5.65	4.75
1 year AAA Bond	6.25	5.75	5.00
5 year AAA Bond	7.60	7.40	6.50
20 year AAA Bond	9.90	9.75	8.15

This information represents prevailing market yields.

It should not be construed as an offering.

All yields are on the offered side of the market.

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